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Budget Driver: Federal Funds

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Key Points

- Since 1994-95, federal government aid to Texas has increased nearly 300 percent.
- Over 35 percent, or $65.5 billion, of the current budget is funded by federal funds, with the majority of federal money, $36.6 billion, going to support Health and Human Service agencies.
- Federal funds negatively impact the state's economy, increase state spending, lead to a decline in state tax revenue, and restrict policymaking decisions.

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At $182.2 billion, Texas' two-year budget dwarfs most other states by comparison.[1] In fact, Texas will outspend all but two other states—California[*] and New York[†]—in fiscal years 2010 and 2011.[2]

To pay for all that state spending, officials rely on five sources of revenue: taxes, fees, the federal government, the lottery, and interest income.[3] Of these major revenue sources, taxes[‡] contribute the most to state coffers—just over 40 percent—but another revenue source is beginning to challenge taxes for the top spot: the federal government.[4]

Currently, aid from the federal government accounts for over one-third of the All Funds budget, or about $65.5 billion of the $182.2 billion total.[5] This, compared to the $77.7 billion in estimated tax revenue, makes federal funding a close second in terms of revenue.

As such a large source of funding, several questions arise. Have federal funds always played such a prominent role in the state's budget? Where are these funds being spent? And what are the consequences, if any, of relying so heavily on federal aid?

To answer these questions and better understand the impact of federal funds on Texas, this research examines the current state of federal funding and the role it plays within the state budget.

Growth of Federal Funds in the State Budget

Texas' reliance on federal funds—which include grants, payments, and reimbursements from the federal government to state agencies—has seen a marked increase over the past several biennia.[§]

Since 1994-95, federal funds have grown from $22.3 billion to $65.5 billion in the current biennium—an increase of 294 percent.[6] As compared to the overall growth in the budget, 260 percent, and the growth of the state's own resources,[**] 244 percent, the increase in federal aid has surpassed both over the same period.[7]

As a percentage of the total budget, federal funds were approximately 32 percent

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[*] California's estimated All Funds total for FY 2010 and FY 2011 is $189.8 billion. Figures do not include Governor Schwarzenegger's proposed budget solutions.

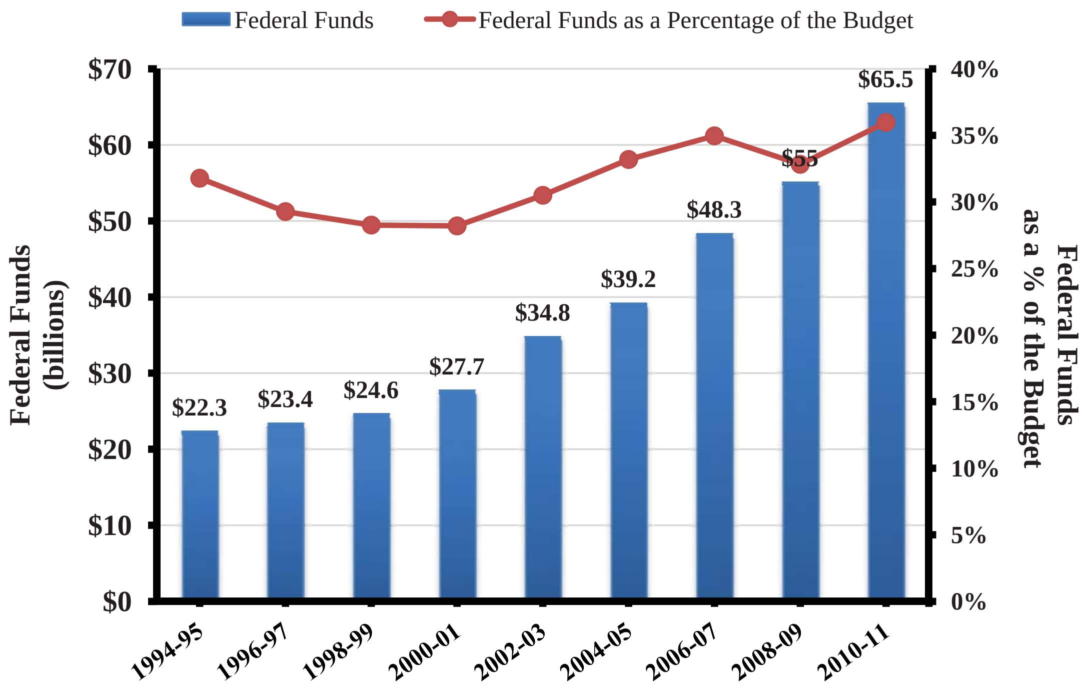
[†] New York estimated All Funds total for FY 2010 and FY 2011 is $267.1 billion. Figures include the FY 2010 revised total and the FY 2011 proposed total.

[‡] For the 2010-11 biennium, the three largest tax revenue sources were the sales tax, $43.8 billion, the revised franchise tax, $8.7 billion, and the motor fuel tax, $6.3 billion, according to the Legislative Budget Board.

[§] For a more comprehensive definition of Federal Funds, please refer to the Senate Research Center's *Budget 101: A Guide to the Budget Process in Texas*, http://www.senate.state.tx.us/SRC/pdf/Budget101-2009-web.pdf.

[**] State funds include the General Revenue Fund, the General Revenue-Dedicated Fund, and Other Funds.

Growth of Federal Funds



Source: Legislative Budget Board

in 1994-95 and experienced a slight decline over the next three biennia. Then, in 2000-01, the percentage of federal funds in the state budget began to rise from 28.2 percent to its current level of 36 percent. Until recently, each biennial budget has seen a 1-2 percentage point increase in the percentage of federal funds. However, the share actually dipped in 2008-09.

Federal Funds in the 2010-11 Budget

For the current budget, federal funds constitute 36 percent, or $65.5 billion, of total appropriations.[8] This marks an increase of $10.5 billion, or 19 percent, above federal fund appropriations for the 2008-09 budget. Much of this gain comes from the American Recovery and Reinvestment Act.*

Of the $65.5 billion in current federal aid, Health and Human Services agencies were by far the biggest recipients with an estimated $36.6 billion—or more than half the total. Most of the $36.6 billion, or 61.4 percent, is directed at the Health and Human Services Commission which oversees Medicaid and the Children's Health Insurance Program.[9]

The second largest area of federal financial aid, public and higher education, totaled $15.6 billion, of which the bulk—upwards of 95 percent—was sent to the Texas Education Agency.[10]

The third largest area, Business and Economic Development, totaled approximately $10.6 billion in federal funds—an increase of approximately 8 percent over the

* According to the Legislative Budget Board's "Fiscal Size-up," the American Recovery and Reinvestment Act provided Texas with $12 billion in federal funds for the 2010-11 biennium, http://www.lbb.state.tx.us/Fiscal_Size-up/Fiscal%20Size-up%202010-11.pdf.

last budget's total. Within the Business and Economic Development function, two agencies received the majority of federal funding—the Texas Department of Transportation and the Texas Workforce Commission. Together, these two agencies received almost 90 percent of Business and Economic Development federal funds.[11]

Consequences of Greater Federal Involvement

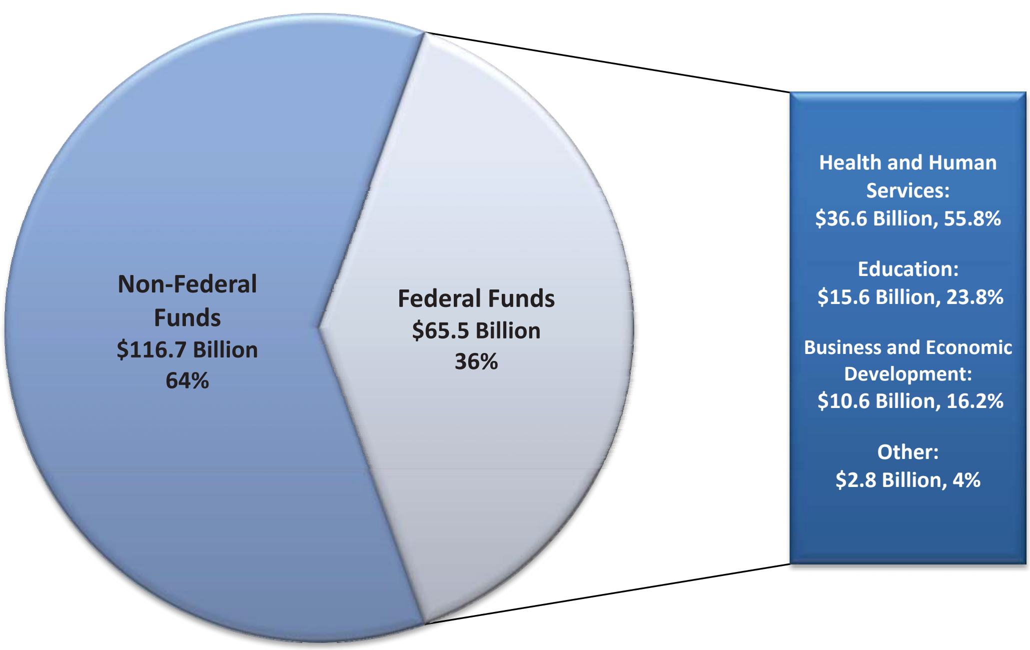
All of this is to say that the role of the federal government in the state's fiscal and policymaking decisions is big and getting bigger.

Now, for some, it may be tempting to dismiss the federal government's expanding role in the state's budgeting affairs as nothing more than good fortune; but as previous academic research and experiential knowledge have proven, "free" federal dollars come with a price and a high level of dependency on federal aid yields unintended consequences. They include:

- **Negative Economic Growth:** In their research, *Do Federal Matching Funds Inhibit State Growth*, Rossen Valchev and Antony Davies estimate the impact on Texas' Gross State Product (GSP) from a relatively small increase, 1 percent, in Federal Matching Funds over a 1 and 10-year period.

  "To put these numbers in perspective: Texas has a GSP of approximately $1 trillion and receives approximately $20 billion in Federal Matching Funds. A 1 percent increase in Federal Matching Funds gains Texas $200 million. According to our short-term model, this $200 million inflow will be associated with a 0.18 percent decline in GSP growth—that will cost Texas $1.8 billion in lost GSP in the first year. According to our long-term model, over the course of 10 years, the 1 percent increase in Federal Matching Funds will be associated with a total loss of 0.62 percent in GSP. **In other words, over the course of 10 years, the $200 million inflow in Federal Matching Funds will be gained at a cost of $6 billion in lost GSP."**[12] [Emphasis by author.]

Federal Funds as a Percentage of the 2010-11 Texas Budget



Source: Legislative Budget Board
Note: Figures may not add due to rounding.

Breaking through the perception that federal dollars are "free" and that the state needs to get its "fair share" is vital to keeping Texas on the path of fiscal responsibility.

Valchev and Davies go on to conclude in their research that federal monies, even in the relatively small amount described above, dramatically decrease economic output over the short-term *and* the long-term because they introduce lasting structural distortions into the recipient state government.

- **Increased State Spending:** Typically, the receipt of federal funds requires a state to make mandatory matching contributions based on pre-established ratios or maintain a certain threshold of state spending, called Maintenance of Effort (MOE). The result of meeting these federal requirements is to increase state government expenditures, or at best, hold them steady.

  Some may argue that the increase in state government expenditures is justified due to the benefits that come with it; but research has shown that, more often than not, state governments use federal monies to fuel consumption rather than investment.

  In their research, *Federal Aid: The Forgotten Variable in State Policy Research*, James Strouse and Phillipe Jones show a strong correlation between federal monies and state government consumption between 1940 to 1968.[13]

- **Declining Tax Revenue:** Valchev and Davies argue that "to obtain Federal money, the state augments its spending which expands the size of the public sector at the expense of the private sector."[14] In other words, as government spending increases, there are fewer resources available to the private sector—which produces income for the public sector.

  It is estimated that a "1 percent increase in Federal Matching Funds ($200 million) will be associated with a decline in state tax revenues of approximately $110 million."[15] This conclusion is certainly supported by the current decline in tax revenue and corresponding increases in federal aid.

- **Handicapping State Decisions:** Aid from the federal government often requires a state to enact certain statutory changes that conform to a set of national standards. Enacting these proposed changes almost always has consequences for a state's ability to hold down the growth of future spending.

  For example, during the stimulus debate last year, Texas could have been eligible for an additional $555 million in Unemployment Insurance (UI) funds had the Legislature modified state law to increase the program's benefits and expand eligibility.[16]

  Even though the one-time receipt of $555 million federal funds would have helped shore up a UI trust fund deficit, the statutory changes would have been near-permanent, meaning a $76.5 million annual tax increase, ad infinitum.[17]

  In the end, the Legislature chose to forgo the $555 million in extra federal aid citing concerns that the ongoing costs associated with expanding the program outweighed the short-term benefit to the state. However, Texas was among a minority of states to reject UI funds.

Conclusion

At $65.5 billion, or 36 percent, of the All Funds budget, federal financial aid contributes a significant amount to the state's budget. If trends continue on a similar trajectory, the federal government may very well overtake state taxes as the number one source of state revenue.

Receiving federal aid, even in small amounts, has a detrimental impact on the state's economy: increases state government spending as officials try to maximize federal revenue; leads to a decline in state tax revenue; and restricts the ability of state lawmakers to control the growth of the budget.

Breaking through the perception, held by some, that federal dollars are "free" and that the state needs to get its "fair share" is vital to controlling the growth of the state's budget and keeping Texas on the path of fiscal responsibility. ✯

Endnotes

[1] Legislative Budget Board, *Fiscal Size-up 2010-11 Biennium* (Dec. 2009) http://www.lbb.state.tx.us/Fiscal_Size-up/Fiscal%20Size-up%20 2010-11.pdf.

[2] California Governor's 2010-11 Budget Summary, http://www.ebudget.ca.gov/pdf/BudgetSummary/FullBudgetSummary.pdf; and New York Budget Summary, http://publications.budget.state.ny.us/eBudget1011/fy1011littlebook/FinancialPlan.html.

[3] Senate Research Center, *Budget 101: A Guide to the Budget Process in Texas* (Jan. 2009) http://www.senate.state.tx.us/SRC/pdf/Budget101-2009-web.pdf.

[4] Legislative Budget Board, *Fiscal Size-up 2010-11 Biennium* (Dec. 2009) http://www.lbb.state.tx.us/Fiscal_Size-up/Fiscal%20Size-up%20 2010-11.pdf.

[5] Ibid.

[6] Author calculations based on Legislative Budget Board data.

[7] Ibid.

[8] Legislative Budget Board, *Fiscal Size-up: 2010-11 Biennium* (Dec. 2009) http://www.lbb.state.tx.us/Fiscal_Size-up/Fiscal%20Size-up%20 2010-11.pdf.

[9] Ibid.

[10] Ibid.

[11] Ibid.

[12] Valchev, Rossen and Antony Davies, "Do Federal Matching Funds Inhibit State Growth," The Mercatus Center at George Mason University (Aug. 2008) http://mercatus.org/publication/do-federal-matching-funds-inhibit-state-growth.

[13] Strouse, James C. and Phillipe Jones, "Federal Aid: The Forgotten Variable in State Policy Research," *Journal of Politics* 36: 200-207.

[14] Valchev, Rossen and Antony Davies, "Do Federal Matching Funds Inhibit State Growth," The Mercatus Center at George Mason University (Aug. 2008) http://mercatus.org/publication/do-federal-matching-funds-inhibit-state-growth.

[15] Ibid.

[16] Quintero, James, "Correct Call to Reject Federal UI Strings," Texas Public Policy Foundation (17 Mar. 2009) http://www.texaspolicy.com/commentaries_single.php?report_id=2500.

[17] Arduin, Laffer & Moore Econometrics, LLC, "The Economic Impact of Federal Spending on State Performance: A Texas Perspective," Texas Public Policy Foundation (Apr. 2009) http://www.texaspolicy.com/pdf/2009-04-federalspending-laffer-final.pdf.

About the Author

The Honorable Talmadge Heflin is the Director of the Texas Public Policy Foundation's Center for Fiscal Policy. For 11 terms, Heflin served the people of Harris County as a state representative. Well regarded as a legislative leader on budget and tax issues by Democratic and Republican speakers alike, he for several terms was the only House member to serve on both the Ways and Means and Appropriations committees.

In the 78th Session, Heflin served as chairman of the House Committee on Appropriations. He navigated a $10 billion state budget shortfall through targeted spending cuts that allowed Texans to avoid a tax increase.

Originally from Webster Parish, Louisiana, Heflin has been a resident of Houston for over 35 years. Prior to his legislative service, he was a member of the Board of Trustees at Alief Independent School District. He is past president of the Texas Conservative Coalition, a member of numerous local civic organizations, serves as a deacon at First Baptist Church Alief, and is a member of the Board of the West Houston Medical Center. He is also the namesake of Talmadge L. Heflin Elementary School in Alief, which opened in 1982 in honor of his service to Alief ISD.

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The Foundation's mission is to promote and defend liberty, personal responsibility, and free enterprise in Texas by educating and affecting policymakers and the Texas public policy debate with academically sound research and outreach. Our goal is to lead the nation in public policy issues by using Texas as a model for reform.

The work of the Foundation is primarily conducted by staff analysts under the auspices of issue-based policy centers. Their work is supplemented by academics from across Texas and the nation.

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The public is demanding a different direction for their government, and the Texas Public Policy Foundation is providing the ideas that enable policymakers to chart that new course.

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